2007 ABA ANNUAL MEETING

SECTION OF BUSINESS LAW

Important Case Law Developments for Partnerships
and Limited Liability Companies

2006-2007 SUPPLEMENT TO

CUMULATIVE SURVEY OF DELAWARE CASE LAW

RELATING TO

ALTERNATIVE ENTITIES*

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* The entire Cumulative Survey is available on the Morris Nichols website at www.MNAT.com under Publications/Treatises and General Publications.

II. LIMITED PARTNERSHIPS

B. Inspection of Partnership Books and Records

1. *Holman v. Northwest Broadcasting, L.P.,* C.A. No. 1572-VCN, (Del. Ch. March 29, 2007)

Plaintiff, a limited partner of the defendant limited partnership, brought a books and records action under DRULPA and the defendant's partnership agreement. Plaintiff's purported purposes were to value his investment and to investigate possible mismanagement of the limited partnership. Prior to this action, plaintiff had been awarded on an ongoing basis a schedule of partnership distributions and audited annual and quarterly financial statements.

Plaintiff's claim for a valuation was based on an 11 year absence of a liquidity opportunity and a buyout potential by the controlling interest holder. The court confirmed that valuation was a proper purpose for seeking an inspection, but noted that such inspection was limited to information that was "essential and sufficient" to accomplish that purpose. The court recognized that in the case of a privately held entity, broader access may be granted since information is less readily available, and in determining what information is "essential and sufficient," the court agreed that "[e]xecutive compensation, in the context of a closely held partnership, is relevant to [a partner's] valuation of his interest." However, the court refused to reexamine the independent auditor's assessment of what constituted material financial information (the information already granted to plaintiff) and held that the evidence of executive compensation, in conjunction with the audited annual and quarterly financial statements already being provided, was all that was "necessary and sufficient" for a valuation without further evidence showing that other omitted information was necessary or essential for completing the valuation.

Plaintiff also identified as a purported purpose his desire to investigate breaches of fiduciary duty and mismanagement. The Court rejected this claim noting that a plaintiff must prove that he has some credible evidence of possible wrongdoing sufficient to warrant continued investigation, and distinguished prior cases that involved either self-dealing or far greater financial irregularities. Finally, the Court added that a simple allegation that the general partner had an incentive to artificially depress cash flows, without more, was too broad and an insufficient reason to grant an inspection, stating that plaintiff's allegation was nothing more than an assertion that "any time a general partner has control over financial statements he will always have some incentive to game them" which, if accepted, would mean that a proper purpose would always exist.

C. Removal of General Partners

1. *Hillman v. Hillman*, 2006 WL 2434231 (November 16, 2006)

The plaintiff was general partner of Venhill Limited Partnership L.P., a Delaware limited partnership ("Venhill"). Two trusts served as the limited partners of Venhill. The plaintiff, in his capacity as general partner, invested 1% of the initial capital and each of the trusts contributed 49.5% of the initial capital. The limited partners challenged the plaintiff's actions in causing Venhill to invest a substantial amount of Venhill's assets in Auto-trol ("Auto-trol"), a company founded and controlled by the plaintiff. Unable to resolve the dispute over Venhill's investment in Auto-trol, the limited partners removed the plaintiff as general partner.

The plaintiff filed suit seeking declaratory judgment that upon his removal he had converted his general partner interest into a limited partner interest in Venhill. The suit also alleged that the limited partners breached fiduciary duties owed to him as a limited partner by the actions they took following his removal. The court concluded that Venhill's limited partnership agreement (the "Agreement") did not provide a general partner the right to "elect" to become a limited partner when removed by the limited partners and thus dismissed his claim for a declaratory judgment that he was a limited partner. The court then discussed what rights the plaintiff possessed following his removal.

The court first noted that the Agreement did not provide what a removed general partner would receive in consideration of its interest upon removal. It then reviewed the DRULPA provisions and related legislative history governing the withdrawal of a general partner. Under Section 17-604, a "withdrawing partner" upon withdrawal will be entitled to receive any distribution to which it was entitled under the partnership agreement and if not otherwise provided for in the partnership agreement, the partner shall be entitled to receive the fair value of its partnership interest. The plaintiff argued that Section 17-604 applied to all types of withdrawals by a general partner, while the defendants argued that Section 17-604 was intended to apply only to *voluntary* withdrawals made pursuant to Sections 17-602 and 17-603. The court agreed with the defendants and concluded that the narrower reading of Section 17-604 presented fewer conflicts and was "more consistent with the structure and language of the statute and the legislative history." Thus, Section 17-604 did not apply to the plaintiff because he did not voluntarily withdrawal under Section 17-602.

Having concluded that Section 17-604 did not apply to the plaintiff, the court sought to determine what effect the plaintiff's involuntary withdrawal would have on his economic stake in the partnership. The court noted that under Section 17-1105, if DRULPA is silent on an issue, "an applicable provision of the Delaware Uniform Partnership Law in effect on July 11, 1999 (the "DUPL") and the rules of law and equity… shall govern." Turning to the DUPL, the court first noted that it did not explicitly address the scenario of a partner who is expelled pursuant to a partnership agreement that permits both his expulsion and the continuation of the partnership business thereafter. Rather, the court found that the DUPL confronted this issue obliquely in Section 1538(a) which entitled an expelled partner to receive the net amounts due from the partnership provided he was discharged from all partnership liabilities by agreement or payment. Turning to the commentary on the uniform act that formed the basis of the DUPL, the court concluded that the amount an expelled partner would be entitled to receive under Section 1538(a) should be equivalent to "fair value." The court thus held that the provisions of the DUPL that were most relevant to the facts before it were best read as pointing to a fair value payout. The court bolstered this conclusion by looking to the Delaware Revised Uniform Partnership Act (the "DUPA") which generally superseded DUPL except that the DUPL rather than the DRUPA continued to be linked to the DRULPA. The court stated that the DRUPA provided the best indication of what equity as the ultimate default required in the context of the present case and found that under the DRUPA, the plaintiff would also be entitled to the fair value of his economic interest.

Finally, because the plaintiff was removed as a general partner and all of the plaintiff's other claims related to the partnership's conduct following his removal, the plaintiff lacked standing and his other claims for breach of fiduciary and contractual duties were also dismissed.

J. Procedural Issues

11. *Standing*

a. *Hillman v. Hillman*, 2006 WL 2434231 (November 16, 2006)

The plaintiff was general partner of Venhill Limited Partnership L.P., a Delaware limited partnership ("Venhill"). Two trusts served as the limited partners of Venhill. The plaintiff, in his capacity as general partner, invested 1% of the initial capital and each of the trusts contributed 49.5% of the initial capital. The limited partners challenged the plaintiff's actions in causing Venhill to invest a substantial amount of Venhill's assets in Auto-trol ("Auto-trol"), a company founded and controlled by the plaintiff. Unable to resolve the dispute over Venhill's investment in Auto-trol, the limited partners removed the plaintiff as general partner.

The plaintiff filed suit seeking declaratory judgment that upon his removal he had converted his general partner interest into a limited partner interest in Venhill. The suit also alleged that the limited partners breached fiduciary duties owed to him as a limited partner by the actions they took following his removal. The court concluded that Venhill's limited partnership agreement (the "Agreement") did not provide a general partner the right to "elect" to become a limited partner when removed by the limited partners and thus dismissed his claim for a declaratory judgment that he was a limited partner. The court then discussed what rights the plaintiff possessed following his removal.

The court first noted that the Agreement did not provide what a removed general partner would receive in consideration of its interest upon removal. It then reviewed the DRULPA provisions and related legislative history governing the withdrawal of a general partner. Under Section 17-604, a "withdrawing partner" upon withdrawal will be entitled to receive any distribution to which it was entitled under the partnership agreement and if not otherwise provided for in the partnership agreement, the partner shall be entitled to receive the fair value of its partnership interest. The plaintiff argued that Section 17-604 applied to all types of withdrawals by a general partner, while the defendants argued that Section 17-604 was intended to apply only to *voluntary* withdrawals made pursuant to Sections 17-602 and 17-603. The court agreed with the defendants and concluded that the narrower reading of Section 17-604 presented fewer conflicts and was "more consistent with the structure and language of the statute and the legislative history." Thus, Section 17-604 did not apply to the plaintiff because he did not voluntarily withdrawal under Section 17-602.

Having concluded that Section 17-604 did not apply to the plaintiff, the court sought to determine what effect the plaintiff's involuntary withdrawal would have on his economic stake in the partnership. The court noted that under Section 17-1105, if DRULPA is silent on an issue, "an applicable provision of the Delaware Uniform Partnership Law in effect on July 11, 1999 (the "DUPL") and the rules of law and equity… shall govern." Turning to the DUPL, the court first noted that it did not explicitly address the scenario of a partner who is expelled pursuant to a partnership agreement that permits both his expulsion and the continuation of the partnership business thereafter. Rather, the court found that the DUPL confronted this issue obliquely in Section 1538(a) which entitled an expelled partner to receive the net amounts due from the partnership provided he was discharged from all partnership liabilities by agreement or payment. Turning to the commentary on the uniform act that formed the basis of the DUPL, the court concluded that the amount an expelled partner would be entitled to receive under Section 1538(a) should be equivalent to "fair value." The court thus held that the provisions of the DUPL that were most relevant to the facts before it were best read as pointing to a fair value payout. The court bolstered this conclusion by looking to the Delaware Revised Uniform

Partnership Act (the "DUPA") which generally superseded DUPL except that the DUPL rather than the DRUPA continued to be linked to the DRULPA. The court stated that the DRUPA provided the best indication of what equity as the ultimate default required in the context of the present case and found that under the DRUPA, the plaintiff would also be entitled to the fair value of his economic interest.

Finally, because the plaintiff was removed as a general partner and all of the plaintiff's other claims related to the partnership's conduct following his removal, the plaintiff lacked standing and his other claims for breach of fiduciary and contractual duties were also dismissed.

P. Forfeiture of Interests

1. *Hillman v. Hillman*, 2006 WL 2434231 (November 16, 2006)

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Having concluded that Section 17-604 did not apply to the plaintiff, the court sought to determine what effect the plaintiff's involuntary withdrawal would have on his economic stake in the partnership. The court noted that under Section 17-1105, if DRULPA is silent on an issue, "an applicable provision of the Delaware Uniform Partnership Law in effect on July 11, 1999 (the "DUPL") and the rules of law and equity… shall govern." Turning to the DUPL, the court first noted that it did not explicitly address the scenario of a partner who is expelled pursuant to a partnership agreement that permits both his

expulsion and the continuation of the partnership business thereafter. Rather, the court found that the DUPL confronted this issue obliquely in Section 1538(a) which entitled an expelled partner to receive the net amounts due from the partnership provided he was discharged from all partnership liabilities by agreement or payment. Turning to the commentary on the uniform act that formed the basis of the DUPL, the court concluded that the amount an expelled partner would be entitled to receive under Section 1538(a) should be equivalent to "fair value." The court thus held that the provisions of the DUPL that were most relevant to the facts before it were best read as pointing to a fair value payout. The court bolstered this conclusion by looking to the Delaware Revised Uniform Partnership Act (the "DUPA") which generally superseded DUPL except that the DUPL rather than the DRUPA continued to be linked to the DRULPA. The court stated that the DRUPA provided the best indication of what equity as the ultimate default required in the context of the present case and found that under the DRUPA, the plaintiff would also be entitled to the fair value of his economic interest.

Finally, because the plaintiff was removed as a general partner and all of the plaintiff's other claims related to the partnership's conduct following his removal, the plaintiff lacked standing and his other claims for breach of fiduciary and contractual duties were also dismissed.

III. LIMITED LIABILITY COMPANIES

A. Fiduciary Duties

1. *Bakerman v. Sidney Frank Importing Co., Inc.*, C.A. No. 1844-N (Del. Ch. Oct. 10, 2006)

Plaintiff was chief legal counsel to Sidney Frank Importing Co., Inc. ("SFIC") and individually owned a membership interest in a subsidiary of SFIC, Grey Goose LLC (the "LLC"). SFIC and the LLC conducted the Grey Goose vodka business. Despite plaintiff's position as chief legal counsel, management of SFIC and the LLC negotiated a sale of the vodka business without the knowledge of plaintiff. Shortly before the scheduled public announcement of the sale, management of the LLC advised plaintiff of the sale and requested plaintiff's consent to the sale in his capacity as a member of the LLC, which was required under the LLC's operating agreement. Of the $2.25 billion dollar cash purchase price, less than 0.49% was proposed to be allocated to the LLC, and on this basis plaintiff initially refused to give his consent. After management threatened to sue plaintiff and terminate his employment, plaintiff consented to the sale. Plaintiff then brought this action, which alleged several derivative and direct claims. In this decision, the court addressed defendants' motion to dismiss.

The court first addressed defendants' motion to dismiss plaintiff's derivative claims for failure to make a proper demand. The court stated that the standard for alleging demand futility in Delaware (as established in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)) requires the pleading of particularized facts raising a reasonable doubt that (i) management is disinterested and independent or (ii) the contested transaction was otherwise the result of a valid exercise of business judgment. As to the first element of the first prong, the court stated that "disinterested" means that a manager is not on both sides of the transaction and is not due to receive a benefit from the transaction that is not shared by the company or other interest holders. In this case, the court determined that the substantial benefit that the managers of the LLC received in their capacity as shareholders of SFIC, at the expense of the LLC, satisfied this element of demand-futility. As to the second element of the first prong, the court stated that the independence of a manager is sufficiently compromised for the purposes of demand-futility when the manager is beholden to a controlling person or so under the influence of a controlling person that the manager's discretion is effectively sterilized. In this case, the control that SFIC and Sidney Frank, who was the founder, chairman, chief executive

officer and majority shareholder of SFIC, exerted with respect to the LLC and the sale transaction created a reasonable doubt as to the independence of the managers of the LLC. Despite concluding that demand was excused under the first prong, the court went on to analyze the second prong of the demand-futility test. The court stated that managers of an LLC are presumed to have acted on an informed basis and in the honest belief that their decisions were in furtherance of the LLC and its members. The court stated that, in determining whether such a presumption is overcome by the facts, which typically requires a showing tantamount to corporate waste, both the substance of the transaction and the process by which it was adopted are reviewed. As to the substance of the transaction, the court found that under the facts presented it could not be reasonably concluded that the allocation of the purchase price between SFIC and the LLC was appropriate. As to process, plaintiff alleged that defendants failed to utilize mechanisms typically employed to produce a fair process, such as obtaining an independent appraisal of the assets or appointing a special committee to assess the fairness of the transaction. The court thus held that plaintiff had met his burden of demonstrating demand futility.

Defendants also alleged that plaintiff was an inadequate derivative representative of the LLC because (i) at the time of the sale he was SFIC's chief legal counsel, (ii) he allegedly violated New York's attorney disciplinary rules by accepting an interest in the LLC while serving as SFIC's legal counsel and (iii) the lawsuit was not supported by other members of the LLC. The court found that plaintiff's position as legal counsel to SFIC did not preclude him from bringing a derivative suit because, as defendants excluded him from the negotiations regarding the sale, he never served as legal advisor on the transaction, and thus his representation of SFIC did not involve issues that were "substantially related" to the derivative claims. In addition, the court found that the derivative claims may be maintained without the support of the other members of the LLC, stating that a derivative representative is assessed by his ability to advance the interest of similarly situated interest holders (even if there is only one interest holder with such interest), regardless of the support of other interest holders.

Turning to the substance of plaintiff's derivative claims, the court first addressed plaintiff's claim of breach of fiduciary duty based on the alleged coercion that led plaintiff to consent to the sale. The court disagreed with plaintiff's assertion that the inequitable coercion doctrine, which is the doctrine Delaware courts have applied in the context of proxy voting by diffuse shareholders of public corporations, was applicable in this case. The court found that this doctrine was not applicable to a member of a closely held LLC, which, unlike diffuse shareholders, is not hampered by the difficulties of collective action. Instead, the court applied the standards relating to coercion and duress in bilateral contract negotiations, stating that a party alleging coercion or duress must plead (i) a wrongful act, (ii) which overcomes the will of the aggrieved part and (iii) that he has no adequate legal remedy to protect himself. The court determined that the application of these standards in this context by the fact that the managers of the LLC, in their position as fiduciaries, had a duty to disclose to plaintiff any information that carried a substantial likelihood that a reasonable interest holder would view as significantly changing the total mix of information bearing on the decision. The court concluded that the threats of litigation and loss of employment, combined with the brief time period in which plaintiff was forced to make a decision without the assistance of counsel, coerced his consent, and thus the court refused to dismiss these claims.

The court then examined defendants' allegations that plaintiff's direct claims were in fact derivative in nature. The court stated that the classification of a claim as derivative or direct turns on (i) who suffered the harm (the company or the suing interest holder individually) and (ii) who would receive the benefit of the remedy (the company or the interest holder individually). Based on this test, plaintiff's breach of contract and breach of good faith and fair dealing claims were judged to be direct because plaintiff suffered the unique harm of the deprivation of his voting rights under the LLC's operating

agreement through the defendants' economic coercion and the remedy for such harm would be due solely to plaintiff. The court thus concluded that these claims were direct claims and determined that plaintiff's pleadings with respect to these claims were sufficient to survive defendants' motion to dismiss.

C. Indemnification and Advancement

1. *Majkowski v. American Imaging Management Services, LLC,* 913 A.2d 572 (Del. Ch. 2006)

Plaintiff, a former president and chief financial officer of American Image Management, Inc., an Illinois corporation ("AIM"), sought a declaration that he was entitled to advancement by American Image Management Services, LLC and American Imaging Management East, LLC, both of which were affiliates of AIM and Delaware limited liability companies (the "LLCs"), of his attorney's fees and expenses in connection with a dispute between plaintiff and AIM and another related company. The LLCs moved to dismiss for failure to state a claim asserting first that plaintiff's claim was subject to mandatory arbitration and, second, that as a substantive matter he had no rights to advancement. The court held that the claim was not subject to arbitration but agreed with defendants that plaintiff did not have a right to advancement and, therefore, granted the motion to dismiss.

In determining whether plaintiff's claim was subject to mandatory arbitration, the court had to determine whether the claim arose under a consulting agreement between AIM and another company for which plaintiff worked and which provided for mandatory arbitration of all claims arising thereunder. Although the court acknowledged that the arbitration clause was broad and that Delaware public policy favored arbitration, it concluded that plaintiff's claims arose by operation of Delaware law independent of the consulting agreement and that plaintiff had rights under the LLC agreements of the LLCs by virtue of his having been an officer of AIM. Consequently, the court held that plaintiff's claim was not subject to arbitration under the consulting agreement. However, in analyzing plaintiff's substantive claim, the court noted that Delaware law had traditionally recognized that indemnification and advancement were two distinct and different legal rights with the latter being a narrower and more provisional subset of the former. While the LLC agreements of the two LLCs contained indemnification language, the court noted that it was undisputed that they contained no express mention of any mandatory advancement rights. Plaintiff attempted to find an advancement right in the phrase "hold harmless" but the court was unpersuaded and held that plaintiff had no rights to advancement and, therefore, dismissed the claim.

2. *Citrin v. Int'l Airport Centers, LLC*, C.A. No. 2005-N (Del. Ch. Sept. 7, 2006)

This decision of the Court of Chancery followed a ruling by a federal appeals court (see *Int'l Airport Centers, LLC v. Citrin*, 455 F.3d 749 (7th Cir. 2006)) that a claim for advancement may be litigated outside of the lawsuit giving rise to such claim, which allowed this action in the Court of Chancery to proceed. Having previously determined in a judgment on the pleadings that the underlying lawsuit implicated plaintiff's right to advancement under the operative limited liability company agreement, the remaining issue addressed by the court in this opinion was whether plaintiff was entitled to pre-judgment interest on the amounts for which plaintiff was entitled to advancement. The court stated that when a plaintiff has a contractual right to advancement, as in this case, the time at which the defendant unjustifiably refuses to pay the amount due is the starting point for the accrual of interest, noting that the requirement to pay interest is to ensure that a plaintiff to whom payment was owed does not suffer injury by the defendant's unjustified delay in making such payment. The court acknowledged that in prior cases the time at which interest began to accrue was the time as which the specific amount of

fees and expenses incurred was submitted to the defendant. In this case, however, defendant refused to identify to plaintiff to whom plaintiff should submit his invoices, which precluded plaintiff's submission of invoices specifying his fees and expenses. The court estimated that had defendant identified a person to whom fees and expenses should be sent as requested in plaintiff's demands for advancement, plaintiff would have delivered the invoices within ten days thereafter and thus determined that this was the appropriate date from which interest would accrue on expenses incurred before the date of his first demand and that interest would accrue on all later expenses from the date on which they were paid by plaintiff.

E. Removal of Managing Member

1. *Child Care of Irvine, L.L.C. v. Facchina*, C.A. No. 16227 (Del. Ch. July 15, 1998); *Facchina v. Malley*, C.A. No. 783-N (Del. Ch. July 12, 2006)

Plaintiffs moved for summary judgment on their claim that they validly removed the defendant as the managing member of a Delaware limited liability company. Defendant, in turn, also moved for summary judgment, asserting that the plaintiffs did not have the authority to remove him as managing member. The individual plaintiffs and the defendant had organized a California corporation and entered into a shareholder agreement that appointed the defendant "to manage the corporation in a professional and efficient manner." When the California corporation was unable to obtain "S" corporation status, the plaintiffs and defendant agreed to convert the corporation to a Delaware LLC through a merger solely for the tax benefits. The shareholders of the corporation entered into a shareholder consent in which they approved the merger and a merger agreement, which stated that the LLC would be governed by the LLC agreement in effect immediately prior to the merger, and authorized the defendant to take the actions necessary to effectuate the merger of the California corporation into the Delaware LLC. The defendant formed the Delaware LLC but the plaintiffs and defendant never executed an LLC agreement. The defendant then effected the merger and managed the business of the LLC. The plaintiffs became dissatisfied with the management of the defendant and purported to remove him as manager through the delivery of two resolutions signed by the individual plaintiffs.

The issue before the court was whether a majority of the members of the LLC had the authority to remove the defendant as the managing member. The plaintiffs argued that the parties orally agreed that the provisions of the shareholder agreement would govern the LLC and that the manager could thus be removed if he acted "unprofessionally" or "inefficiently." In the alternative, the plaintiffs argued that there was no LLC agreement and that, under Section 18-402 of the LLC Act, the management of the LLC was vested in the members and, therefore, a majority of the members could remove the defendant. The defendant argued that the plaintiffs had accepted a draft LLC agreement he claimed to have circulated that appointed himself manager and contained no provision for removing the manager. He claimed that under Section 18-402 of the LLC Act, a manager may only be removed as specified in the LLC agreement and, absent a provision for removal, a manager is unable to be removed except through judicial dissolution of the LLC. In the alternative, the defendant argued that the merger agreement, which appointed himself as manager and did not include a removal provision, was the operative LLC agreement. Because facts necessary to resolve the issue were in dispute, the court denied the cross-motions for summary judgment. The court also noted that either of the agreements proffered by the parties as the rightful LLC agreement would require arbitration of the dispute and encouraged the parties to seek arbitration rather than to litigate the case further to determine the rightful LLC agreement and then have the court direct the parties to arbitrate the dispute in accordance with such agreement.

In a related subsequent proceeding, Facchina, the defendant in the prior proceeding, acting in unison with certain other members of the LLC, removed the then current managing member and installed Facchina in that capacity and also caused the LLC to merge with another Delaware LLC. Each of these actions was challenged by plaintiffs on several grounds. However, the court held that since Facchina and those acting in concert with him owned more than a majority of the membership interests in the LLC, pursuant to Section 18-402 of the LLC Act, they could designate Facchina as the managing member.

H. Derivative Actions

1. *JJ&B, LLC v. Joseph Rizzo & Sons Const. Co.,* 2007 WL 1114079 (Del. Ch. 2007)

This was a derivative case involving a family business that had been split up over time into a number of different entities. Plaintiff held an interest in one of the entities, JJ&B, LLC ("JJ&B"). JJ&B owned the real estate on which the family business operated. Plaintiff alleged that the operating entities of the family business (the "Operating Entities") used their control over JJ&B to benefit themselves at the expense of JJ&B's members. Plaintiff alleged that the Operating Entities occupied JJ&B's land without any formal rental agreement and without paying any rent to JJ&B. Plaintiff's derivative claims included separate counts for injunctive relief, unjust enrichment, breach of fiduciary duty, and ejectment.

Defendants asserted that the Court of Chancery lacked subject matter jurisdiction over the ejectment count, and filed a motion to dismiss. Defendants argued that because an action for ejectment is a legal claim and not equitable, the court could not exercise jurisdiction over this count. The court disagreed. The court noted that a derivative claim is cognizable only in equity and held that a derivative action can be brought to enforce a purely legal right of a corporation. Thus, while the ejectment count was a legal claim, the court held that it became a "creature of equity when asserted derivatively," and, therefore, the court had proper jurisdiction over the claim.

2. *Bakerman v. Sidney Frank Importing Co., Inc.*, C.A. No. 1844-N (Del. Ch. Oct. 10, 2006)

Plaintiff was chief legal counsel to Sidney Frank Importing Co., Inc. ("SFIC") and individually owned a membership interest in a subsidiary of SFIC, Grey Goose LLC (the "LLC"). SFIC and the LLC conducted the Grey Goose vodka business. Despite plaintiff's position as chief legal counsel, management of SFIC and the LLC negotiated a sale of the vodka business without the knowledge of plaintiff. Shortly before the scheduled public announcement of the sale, management of the LLC advised plaintiff of the sale and requested plaintiff's consent to the sale in his capacity as a member of the LLC, which was required under the LLC's operating agreement. Of the $2.25 billion dollar cash purchase price, less than 0.49% was proposed to be allocated to the LLC, and on this basis plaintiff initially refused to give his consent. After management threatened to sue plaintiff and terminate his employment, plaintiff consented to the sale. Plaintiff then brought this action, which alleged several derivative and direct claims. In this decision, the court addressed defendants' motion to dismiss.

The court first addressed defendants' motion to dismiss plaintiff's derivative claims for failure to make a proper demand. The court stated that the standard for alleging demand futility in Delaware (as established in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)) requires the pleading of particularized facts raising a reasonable doubt that (i) management is disinterested and independent or (ii) the contested transaction was otherwise the result of a valid exercise of business judgment. As to the first element of the first prong, the court stated that "disinterested" means that a manager is not on both sides of the transaction and is not due to receive a benefit from the transaction that is not

shared by the company or other interest holders. In this case, the court determined that the substantial benefit that the managers of the LLC received in their capacity as shareholders of SFIC, at the expense of the LLC, satisfied this element of demand-futility. As to the second element of the first prong, the court stated that the independence of a manager is sufficiently compromised for the purposes of demand-futility when the manager is beholden to a controlling person or so under the influence of a controlling person that the manager's discretion is effectively sterilized. In this case, the control that SFIC and Sidney Frank, who was the founder, chairman, chief executive officer and majority shareholder of SFIC, exerted with respect to the LLC and the sale transaction created a reasonable doubt as to the independence of the managers of the LLC. Despite concluding that demand was excused under the first prong, the court went on to analyze the second prong of the demand-futility test. The court stated that managers of an LLC are presumed to have acted on an informed basis and in the honest belief that their decisions were in furtherance of the LLC and its members. The court stated that, in determining whether such a presumption is overcome by the facts, which typically requires a showing tantamount to corporate waste, both the substance of the transaction and the process by which it was adopted are reviewed. As to the substance of the transaction, the court found that under the facts presented it could not be reasonably concluded that the allocation of the purchase price between SFIC and the LLC was appropriate. As to process, plaintiff alleged that defendants failed to utilize mechanisms typically employed to produce a fair process, such as obtaining an independent appraisal of the assets or appointing a special committee to assess the fairness of the transaction. The court thus held that plaintiff had met his burden of demonstrating demand futility.

Defendants also alleged that plaintiff was an inadequate derivative representative of the LLC because (i) at the time of the sale he was SFIC's chief legal counsel, (ii) he allegedly violated New York's attorney disciplinary rules by accepting an interest in the LLC while serving as SFIC's legal counsel and (iii) the lawsuit was not supported by other members of the LLC. The court found that plaintiff's position as legal counsel to SFIC did not preclude him from bringing a derivative suit because, as defendants excluded him from the negotiations regarding the sale, he never served as legal advisor on the transaction, and thus his representation of SFIC did not involve issues that were "substantially related" to the derivative claims. In addition, the court found that the derivative claims may be maintained without the support of the other members of the LLC, stating that a derivative representative is assessed by his ability to advance the interest of similarly situated interest holders (even if there is only one interest holder with such interest), regardless of the support of other interest holders.

Turning to the substance of plaintiff's derivative claims, the court first addressed plaintiff's claim of breach of fiduciary duty based on the alleged coercion that led plaintiff to consent to the sale. The court disagreed with plaintiff's assertion that the inequitable coercion doctrine, which is the doctrine Delaware courts have applied in the context of proxy voting by diffuse shareholders of public corporations, was applicable in this case. The court found that this doctrine was not applicable to a member of a closely held LLC, which, unlike diffuse shareholders, is not hampered by the difficulties of collective action. Instead, the court applied the standards relating to coercion and duress in bilateral contract negotiations, stating that a party alleging coercion or duress must plead (i) a wrongful act, (ii) which overcomes the will of the aggrieved part and (iii) that he has no adequate legal remedy to protect himself. The court determined that the application of these standards in this context by the fact that the managers of the LLC, in their position as fiduciaries, had a duty to disclose to plaintiff any information that carried a substantial likelihood that a reasonable interest holder would view as significantly changing the total mix of information bearing on the decision. The court concluded that the threats of litigation and loss of employment, combined with the brief time period in which plaintiff was forced to make a decision without the assistance of counsel, coerced his consent, and thus the court refused to dismiss these claims.

The court then examined defendants' allegations that plaintiff's direct claims were in fact derivative in nature. The court stated that the classification of a claim as derivative or direct turns on (i) who suffered the harm (the company or the suing interest holder individually) and (ii) who would receive the benefit of the remedy (the company or the interest holder individually). Based on this test, plaintiff's breach of contract and breach of good faith and fair dealing claims were judged to be direct because plaintiff suffered the unique harm of the deprivation of his voting rights under the LLC's operating agreement through the defendants' economic coercion and the remedy for such harm would be due solely to plaintiff. The court thus concluded that these claims were direct claims and determined that plaintiff's pleadings with respect to these claims were sufficient to survive defendants' motion to dismiss.

I. Disclosures

1. *Bakerman v. Sidney Frank Importing Co., Inc.*, C.A. No. 1844-N (Del. Ch. Oct. 10, 2006)

Plaintiff was chief legal counsel to Sidney Frank Importing Co., Inc. ("SFIC") and individually owned a membership interest in a subsidiary of SFIC, Grey Goose LLC (the "LLC"). SFIC and the LLC conducted the Grey Goose vodka business. Despite plaintiff's position as chief legal counsel, management of SFIC and the LLC negotiated a sale of the vodka business without the knowledge of plaintiff. Shortly before the scheduled public announcement of the sale, management of the LLC advised plaintiff of the sale and requested plaintiff's consent to the sale in his capacity as a member of the LLC, which was required under the LLC's operating agreement. Of the $2.25 billion dollar cash purchase price, less than 0.49% was proposed to be allocated to the LLC, and on this basis plaintiff initially refused to give his consent. After management threatened to sue plaintiff and terminate his employment, plaintiff consented to the sale. Plaintiff then brought this action, which alleged several derivative and direct claims. In this decision, the court addressed defendants' motion to dismiss.

The court first addressed defendants' motion to dismiss plaintiff's derivative claims for failure to make a proper demand. The court stated that the standard for alleging demand futility in Delaware (as established in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)) requires the pleading of particularized facts raising a reasonable doubt that (i) management is disinterested and independent or (ii) the contested transaction was otherwise the result of a valid exercise of business judgment. As to the first element of the first prong, the court stated that "disinterested" means that a manager is not on both sides of the transaction and is not due to receive a benefit from the transaction that is not shared by the company or other interest holders. In this case, the court determined that the substantial benefit that the managers of the LLC received in their capacity as shareholders of SFIC, at the expense of the LLC, satisfied this element of demand-futility. As to the second element of the first prong, the court stated that the independence of a manager is sufficiently compromised for the purposes of demand-futility when the manager is beholden to a controlling person or so under the influence of a controlling person that the manager's discretion is effectively sterilized. In this case, the control that SFIC and Sidney Frank, who was the founder, chairman, chief executive officer and majority shareholder of SFIC, exerted with respect to the LLC and the sale transaction created a reasonable doubt as to the independence of the managers of the LLC. Despite concluding that demand was excused under the first prong, the court went on to analyze the second prong of the demand-futility test. The court stated that managers of an LLC are presumed to have acted on an informed basis and in the honest belief that their decisions were in furtherance of the LLC and its members. The court stated that, in determining whether such a presumption is overcome by the facts, which typically requires a showing tantamount to corporate waste, both the substance of the transaction and the process by which it was adopted are reviewed. As to the substance of the transaction, the court found that under the facts presented it could not be reasonably

concluded that the allocation of the purchase price between SFIC and the LLC was appropriate. As to process, plaintiff alleged that defendants failed to utilize mechanisms typically employed to produce a fair process, such as obtaining an independent appraisal of the assets or appointing a special committee to assess the fairness of the transaction. The court thus held that plaintiff had met his burden of demonstrating demand futility.

Defendants also alleged that plaintiff was an inadequate derivative representative of the LLC because (i) at the time of the sale he was SFIC's chief legal counsel, (ii) he allegedly violated New York's attorney disciplinary rules by accepting an interest in the LLC while serving as SFIC's legal counsel and (iii) the lawsuit was not supported by other members of the LLC. The court found that plaintiff's position as legal counsel to SFIC did not preclude him from bringing a derivative suit because, as defendants excluded him from the negotiations regarding the sale, he never served as legal advisor on the transaction, and thus his representation of SFIC did not involve issues that were "substantially related" to the derivative claims. In addition, the court found that the derivative claims may be maintained without the support of the other members of the LLC, stating that a derivative representative is assessed by his ability to advance the interest of similarly situated interest holders (even if there is only one interest holder with such interest), regardless of the support of other interest holders.

Turning to the substance of plaintiff's derivative claims, the court first addressed plaintiff's claim of breach of fiduciary duty based on the alleged coercion that led plaintiff to consent to the sale. The court disagreed with plaintiff's assertion that the inequitable coercion doctrine, which is the doctrine Delaware courts have applied in the context of proxy voting by diffuse shareholders of public corporations, was applicable in this case. The court found that this doctrine was not applicable to a member of a closely held LLC, which, unlike diffuse shareholders, is not hampered by the difficulties of collective action. Instead, the court applied the standards relating to coercion and duress in bilateral contract negotiations, stating that a party alleging coercion or duress must plead (i) a wrongful act, (ii) which overcomes the will of the aggrieved part and (iii) that he has no adequate legal remedy to protect himself. The court determined that the application of these standards in this context by the fact that the managers of the LLC, in their position as fiduciaries, had a duty to disclose to plaintiff any information that carried a substantial likelihood that a reasonable interest holder would view as significantly changing the total mix of information bearing on the decision. The court concluded that the threats of litigation and loss of employment, combined with the brief time period in which plaintiff was forced to make a decision without the assistance of counsel, coerced his consent, and thus the court refused to dismiss these claims.

The court then examined defendants' allegations that plaintiff's direct claims were in fact derivative in nature. The court stated that the classification of a claim as derivative or direct turns on (i) who suffered the harm (the company or the suing interest holder individually) and (ii) who would receive the benefit of the remedy (the company or the interest holder individually). Based on this test, plaintiff's breach of contract and breach of good faith and fair dealing claims were judged to be direct because plaintiff suffered the unique harm of the deprivation of his voting rights under the LLC's operating agreement through the defendants' economic coercion and the remedy for such harm would be due solely to plaintiff. The court thus concluded that these claims were direct claims and determined that plaintiff's pleadings with respect to these claims were sufficient to survive defendants' motion to dismiss.

K. Procedural Issues

1. Arbitration

a. *NAMA Holdings, LLC v. Related World Market Center, LLC,* C.A. No. 2755-VCL (Del. Ch. April 27, 2007) and *NAMA Holdings, LLC v. World Market Center Venture, LLC,* C.A. No. 2756-VCL (Del. Ch. April 27, 2007)

In two related cases, plaintiff, a Nevada limited liability company and indirect owner of one of the defendant Delaware limited liability companies, sought to enforce certain provisions in the operating agreement of that LLC with respect to which plaintiff was an intended third party beneficiary. Plaintiff's claims involved a demand for books and records and an action for specific performance limiting distributions and segregating the disputed funds. Defendants asserted that all of plaintiff's claims were subject to mandatory arbitration, that the inspection claim was moot because defendants had already voluntarily provided access to the requested documents and that plaintiff's claim for a specific performance should be dismissed because of failure to join indispensable parties and because plaintiff had an adequate remedy at law. The court rejected defendants' arguments on all grounds. First, it found that the disputes at issue did not come within the ambit of the arbitration language inasmuch as under the arbitration clause neither of the parties to that contract could compel arbitration and, therefore, it would be inequitable to allow them to compel arbitration with a third party beneficiary. The court also ruled that plaintiff had not been provided the requested information and with respect to the claim of indispensable parties held that "merely because a non-joined party may have a claim to a disputed amount does not inevitably deprive a court of the ability to render complete relief to the parties before it." Finally, with regard to defendant's claim that plaintiff could be adequately compensated with money damages and therefore had no right to specific performance, the court held "a remedy at law, i.e. money damages, will foreclose the equitable remedy of specific performance when that remedy is 'complete, practical and as efficient to the end of justice as the remedy in equity, and is obtainable as [a matter] of right'". Under this standard, the court rejected defendants' argument. Under the LLC agreement, the duties of one of the defendants were stated to be purely ministerial in nature and that such defendant would incur no liability for any action taken or omitted under the relevant section except for willful misconduct, gross negligence or bad faith so long as such defendant acted in good faith. Under the standard, the court found that even if plaintiff proved noncompliance by such defendant with the relevant section, such defendant would have no liability if its noncompliance occurred only negligently and in good faith, therefore, plaintiff would be left without a legal remedy against such defendant. Moreover, the court also found that money damages, even if not barred by that section, would fail to provide a complete and efficient remedy to plaintiff. It held that a contractual covenant allowing a party to restrict distributions to others necessarily involved a bargained-for-benefit that money could not adequately compensate. The court held that the "leverage that type of covenant creates provides a 'material commercial advantage' to the party that can invoke it, and for a court to hold that money damages are an appropriate substitute for specific performance in a dispute like this one 'would essentially involve the judicial nullification of the leverage-conferring aspects of such a provision.'"

6. Failure to Join Necessary and Indispensable Parties

a. *NAMA Holdings, LLC v. Related World Market Center, LLC,* C.A. No. 2755-VCL (Del. Ch. April 27, 2007) and *NAMA Holdings, LLC v. World Market Center Venture, LLC,* C.A. No. 2756-VCL (Del. Ch. April 27, 2007)

In two related cases, plaintiff, a Nevada limited liability company and indirect owner of one of the defendant Delaware limited liability companies, sought to enforce certain provisions in the operating agreement of that LLC with respect to which plaintiff was an intended third party beneficiary. Plaintiff's claims involved a demand for books and records and an action for specific performance limiting distributions and segregating the disputed funds. Defendants asserted that all of plaintiff's claims were subject to mandatory arbitration, that the inspection claim was moot because defendants had already voluntarily provided access to the requested documents and that plaintiff's claim for a specific performance should be dismissed because of failure to join indispensable parties and because plaintiff had an adequate remedy at law. The court rejected defendants' arguments on all grounds. First, it found that the disputes at issue did not come within the ambit of the arbitration language inasmuch as under the arbitration clause neither of the parties to that contract could compel arbitration and, therefore, it would be inequitable to allow them to compel arbitration with a third party beneficiary. The court also ruled that plaintiff had not been provided the requested information and with respect to the claim of indispensable parties held that "merely because a non-joined party may have a claim to a disputed amount does not inevitably deprive a court of the ability to render complete relief to the parties before it." Finally, with regard to defendant's claim that plaintiff could be adequately compensated with money damages and therefore had no right to specific performance, the court held "a remedy at law, i.e. money damages, will foreclose the equitable remedy of specific performance when that remedy is 'complete, practical and as efficient to the end of justice as the remedy in equity, and is obtainable as [a matter] of right'". Under this standard, the court rejected defendants' argument. Under the LLC agreement, the duties of one of the defendants were stated to be purely ministerial in nature and that such defendant would incur no liability for any action taken or omitted under the relevant section except for willful misconduct, gross negligence or bad faith so long as such defendant acted in good faith. Under the standard, the court found that even if plaintiff proved noncompliance by such defendant with the relevant section, such defendant would have no liability if its noncompliance occurred only negligently and in good faith, therefore, plaintiff would be left without a legal remedy against such defendant. Moreover, the court also found that money damages, even if not barred by that section, would fail to provide a complete and efficient remedy to plaintiff. It held that a contractual covenant allowing a party to restrict distributions to others necessarily involved a bargained-for-benefit that money could not adequately compensate. The court held that the "leverage that type of covenant creates provides a 'material commercial advantage' to the party that can invoke it, and for a court to hold that money damages are an appropriate substitute for specific performance in a dispute like this one 'would essentially involve the judicial nullification of the leverage-conferring aspects of such a provision.'"

R. Limited Liability Company Agreement

1. *Facchina v. Malley*, C.A. No. 783-N (Del. Ch. July 12, 2006)

This case is one in a long running dispute involving several related Delaware limited liability companies. The disputes generally involve control over the LLCs. In this

opinion, the court found that there was no limited liability company agreement but, nonetheless, still found that there was a limited liability company and that it had members each owning a set, identifiable interest in the LLC, notwithstanding the fact that the LLC Act would seem to require an LLC agreement for various purposes including the determination of the members (*see* Section 18-301 of the LLC Act). The court held in the absence of an LLC agreement, the LLC Act would provide the governing framework for the LLC and that under Section 18-402 of the LLC Act, management of an LLC is vested in the members owning a majority percentage interest in the LLC.

S. Formation

1. *Ramone v. Lang*, C.A. No. 1592-N (Del. Ch. Apr. 3, 2006)

Plaintiff brought this action under theories of breach of contract, breach of fiduciary duty and promissory estoppel based on six months of discussions between plaintiff and defendant that failed to result in the contemplated formalization of their arrangement in an LLC agreement.

Before plaintiff's involvement with defendant, defendant had already signed a purchase agreement to buy property on which plaintiff had considered opening a public swim and fitness center. For months, plaintiff and defendant discussed varying deal terms but were unable to reach a final agreement. While negotiations were ongoing, plaintiff and defendant worked together to have the property rezoned, defendant represented to the press and his financing bank that plaintiff was involved in the project and plaintiff solicited members for a swim team at the property. Ultimately, defendant, frustrated by his inability to reach a final accord with plaintiff, entered into an LLC agreement with three other parties. Plaintiff then filed this action.

The court found that no binding contractual relationship existed between the parties. Plaintiff claimed that, through their e-mail exchanges, the parties established a final, binding agreement as to their respective rights and obligations in an LLC and as to the property. The court cited the general principle of contract formation in Delaware, which does not look to a party's subjective intent but rather requires an "overt" "manifestation of mutual assent to the exchange and consideration." For a party's assent to constitute an acceptance that would form a contract, it must include an expression of commitment that (i) is not conditional on any further act by either party and (ii) is on the terms proposed in the offer without the slightest variation. To be enforceable, a contract must contain all material terms and a court will not order specific performance if, as in this case, it would be required to supply essential terms. In this case, the language used in, and the negotiations that occurred after, the e-mail cited by plaintiff as constituting a final, binding agreement evidenced that a contract had not been formed.

The court then considered the theory of de facto partnership and concluded that a partnership relationship had not been created. Separate from the contractual duties that the court disposed of as discussed above, plaintiff claimed that the parties had become partners and that defendant was in breach of his fiduciary duties. The court stated that under DRUPA Section 15-202 a partnership exists where, regardless of the intent of the parties, two or more persons associate themselves to carry on a business for profit. The level of proof required to establish this type of association is higher in a suit between the alleged partners (as opposed to a suit by a third party). Under Delaware law, "there is no singularly dispositive consideration that determines whether or not a partnership existed," but a court must find a mutual obligation to share profits and losses and may consider the conduct of the parties. In this case, the court, while acknowledging that the lack of written agreement is not necessarily conclusive of the existence of a partnership, found that the absence of such an agreement left it without terms to enforce. In addition, the fact that the fiduciary relationship contemplated by the parties was as members of a

limited liability company counseled against finding that they had created a general partnership. DRUPA Section 15-502 specifically provides that associations formed under other chapters of the Delaware Code are not partnerships and, in the opinion of the court, it would be an odd result that a failed attempt at creating an LLC would place the parties in a partnership. Even given this, however, the court posited that in a situation in which the parties had reached agreement on material terms and one side simply balked on the documentation of the LLC, it might be possible to find that a general partnership had been created. This, however, was not the situation in this case.

The court did find the doctrine of promissory estoppel to be available to plaintiff, as defendant had disappointed the expectation of plaintiff's participation in the property, on which plaintiff had reasonably relied. The court set forth the elements of promissory estoppel under Delaware law, which are clear and convincing evidence of (i) a promise; (ii) the reasonable expectation, from an objective viewpoint, of the promissor to induce action or forebearance by the promissee; (iii) the promissee's actual, reasonable reliance on the promise and action to his detriment and (iv) the binding effect of the promise because without enforcement there would be an injustice. The court espoused its view that the normal failure of parties to reach a binding contract is not grounds for invoking the doctrine and that promissory estoppel should be used in the relatively narrow circumstances in which the legitimate expectations of a party made vulnerable by promises in the negotiation process need to be protected. In this case, the court accepted plaintiff's argument that, even if the parties had not agreed on a final deal structure, the understanding throughout the process was that defendant would make the pool facilities at the property available for plaintiff's use and that plaintiff relied on this promise with the knowledge of defendant.

T. Remedies

1. Specific Performance

a. *NAMA Holdings, LLC v. Related World Market Center, LLC,* C.A. No. 2755-VCL (Del. Ch. April 27, 2007) and *NAMA Holdings, LLC v. World Market Center Venture, LLC,* C.A. No. 2756-VCL (Del. Ch. April 27, 2007)

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